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Neil E. Harl
Iowa State University, harl@iastate.edu

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EXPENSE METHOD DEPRECIATION

— by **Neil E. Harl***

Recently published proposed regulations[1] to the expense method depreciation rules[2] have provided firm guidance on the position of the Department of the Treasury on several key issues involving the 1986 amendments to the expense method depreciation statute.[3]

Taxable income limitation

In the 1986 amendments, the amount of expense method depreciation that could be claimed was limited to the "aggregate amount of the taxable income of the taxpayer for such taxable year that is derived from the active conduct by the taxpayer of any trade or business during such taxable year."[4] The key terms are "taxable income," "active conduct" and "trade or business."

Taxable income. The proposed regulations state that the "taxable income" figure is computed by aggregating the net income or loss from all trades or businesses actively conducted by the individual, partnership or S corporation.[5] The taxable income derived from the active conduct by a corporation (other than an S corporation) of a trade or business is the corporation's taxable income before deducting its net operating loss deduction and special deductions, adjusted to reflect items of income or deduction not derived from a trade or business actively conducted by the corporation.[6] Items of income that are considered to be derived from a trade or business actively conducted by the taxpayer include Section 1231 gains (or losses) from the trade or business and "interest from working capital of the trade or business."[7] The taxable income figure is computed without regard to expense method depreciation claimed, the deduction for one-half of self-employment taxes[8] and any net operating loss carryback or carryforward.[9]

For a taxpayer who is a partner in a partnership and engaged in the active conduct of at least one of the partnership's trades or businesses, the amount of the taxpayer's *allocable share* of taxable income derived from the active conduct by the partnership of any trade or business is counted as taxable income for this purpose.[10] Similar rules are to apply to a taxpayer who is a shareholder in an S corporation and is engaged in the active conduct of the S corporation's trade or business.[11]

Active conduct. The question of whether a trade or business is actively conducted by a taxpayer is subject to a facts and circumstances test and is to be answered in the context of the purpose of the "active conduct" requirement.[12] As the regulations note, the purpose of the requirement was "to prevent a passive investor in a trade or business" from deducting expense method depreciation" against taxable income derived from that trade or business." The proposed regulation on that point could easily be misconstrued — the statute does not limit expense method depreciation to the taxable income from *that* trade or business; the statute clearly states that expense method depreciation may be deducted to the extent of taxable income from *any* trade or business of the taxpayer.[13]

The proposed regulations then introduce a new term in the already overcrowded field of terms describing involvement in a business with "meaningful participation."[14] The regulations state that a taxpayer "generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business."[15]

A partner is generally considered to actively conduct a trade or business of the partnership if the partner "meaningfully participates" in the management or operations of the trade or business.[16] However, a mere passive investor is not considered to actively conduct the trade or business.[17]

A major issue has been whether employees are considered to be engaged in the active conduct of the trade or business of their employment.[18] It had been thought that employees should be considered to be engaged in the active conduct of the trade or business of their employment[19] and the proposed regulations agree with that position.[20] Thus, wages, salaries, tips and other compensation constitute taxable income for the purposes of the "active conduct" requirement.[21]

A further question is whether a *spouse's* W-2 income should be considered the taxpayer's income for this purpose. A 1940 U.S. Supreme Court case, *Helvering v. Janney*,[22] had held that a joint return reflects the activity of a taxable unit "...as though the return were that of a single individual."[23] The proposed regulations take the same position.[24] Thus, if a husband and wife file a joint income tax return, the wife's W-2 wage income can be considered income from the active conduct of a trade or business for either spouse.[25] In the event, however, that married individuals file separately, the husband and wife are treated as separate taxpayers for this purpose.[26]

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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Trade or business. The third and final term of critical importance in the new proposed regulations is "trade or business." The proposed regulations, not surprisingly, take the position that the term "trade or business" has the same meaning as the term has acquired under the code section (Section 162) specifying what expenses are deductible as "ordinary and necessary expenses paid or incurred...in carrying on any trade or business...."[27]

As the proposed regulations point out, property held merely for the production of income[28] or property used in an activity not engaged in for profit[29] does not qualify for expense method depreciation.[30] Thus, taxable income derived from such property is not taken into account for purposes of the taxable income limitation under the expense method depreciation rules.[31]

Carryover of disallowed deduction

The expense method depreciation rules permit a carryover for an unlimited number of years of expense method depreciation disallowed because of the taxable income limitation.[32] The amount deductible in a carryover year is still subject to the maximum limit of $10,000.[33]

The taxable income limitation applies at the partnership level as well as at the partner level.[34] Therefore a partnership may have a carryover of disallowed deductions for expense method depreciation[35] and a partner may have a carryover of disallowed deductions.[36]

The basis of a partnership's expense method depreciation property must be reduced to reflect the amount of expense method depreciation elected by the partnership.[37] This reduction must be made for the year the election is made *even if part or all of the expense method depreciation is carried forward by the partnership* because of the taxable income limitation.[38]

Similarly, a partner who is allocated expense method depreciation from a partnership must reduce the basis of the partner's partnership interest by the full amount of the allocation *even though the partner may not be able to deduct that year the allocated expense method depreciation*.[39] If a partner disposes of a partnership interest, or transfers a partnership interest in a transaction in which gain or loss is not recognized, the partner may have an outstanding carryover of disallowed deduction of expense method depreciation.[40] In that event, the partner's basis in the partnership is increased immediately before the transfer by the amount of the partner's outstanding carryover of disallowed deductions with respect to the partnership interest.[41] The proposed regulations note specifically that the carryover of disallowed deductions is not available to the transferee.[42] The proposed regulations refer to the disallowed deduction not being available *to the transfer of the expense method depreciation property*.[43] This is believed to be in error; the context of the statement is of a transfer of an interest in a partnership, not transfer of the property itself. The latter would likely trigger recapture of the expense method depreciation.[44]

The proposed regulations point out that rules similar to those applicable to partnerships and partners apply to S corporations[45] and their shareholders.[46]

FOOTNOTES

1 56 Fed. Reg. 12868, March 28, 1991, proposing amendments to Treas. Reg. §§ 1.179-1 through 1.179-5, 1.179-0.
2 I.R.C. § 179. See generally 4 Harl, **Agricultural Law** § 29.05[2][b] (1991).
3 See Tax Reform Act of 1986, Sec. 202, 100 Stat. 2085, 2142 (1986).
4 *Id*., Sec. 202(a), 100 Stat. 2143, amending I.R.C. § 179(b)(3)(A).
5 Prop. Treas. Reg. § 1.179-2(c)(4)(i).
6 *Id*.
7 *Id*.
8 I.R.C. § 164(f).
9 Prop. Treas. Reg. § 1.179-2(c)(4)(i).
10 Prop.Treas.Reg.§1.179-2(c)(4)(iii).
11 Prop.Treas.Reg.§ 1.179-2(c)(4)(iv).
12 Prop.Treas.Reg.§ 1.179-2(c)(5)(ii).
13 I.R.C. § 179(b)(3)(A).
14 Prop.Treas.Reg.§ 1.179-2(c)(5)(ii).
15 *Id*.
16 *Id*.
17 *Id*.
18 See 4 Harl, *supra* note 2, § 29.05 [2][b], (Supp. 1991).
19 *Id*.
20 Prop.Treas.Reg.§ 1.179-2(c)(5)(iv).
21 *Id*.
22 311 U.S. 189 (1940).
23 *Id*.
24 Prop. Treas. Reg. § 1.179-2(c)(6).
25 *Id*.
26 Prop. Treas. Reg. § 1.179-2(c)(7).
27 I.R.C. § 162(a).
28 See I.R.C. § 212.
29 See I.R.C. § 183.
30 Prop.Treas.Reg. § 1.179-2(c)(5)(i).
31 *Id*.
32 I.R.C. § 179(b)(3)(B).
33 I.R.C. §§ 179(b)(1), 179(b)(3)(B).
34 I.R.C. § 179(d)(8).
35 Prop. Treas. Reg. § 1.179-3(g)(1).
36 Prop. Treas. Reg. § 1.179-3(h)(1).
37 Prop. Treas. Reg. § 1.179-3(g)(2).
38 *Id*.
39 Prop. Treas. Reg. § 1.179-3(h)(1).
40 Prop. Treas. Reg. § 1.179-3(h)(2).
41 *Id*.
42 *Id*.
43 *Id*.
44 See I.R.C. § 179(d)(10).
45 Prop. Treas. Reg. §§ 1.179-3(g)(1), 1.179-3(g)(2)
46 Prop. Treas. Reg. §§ 1.179-3(h)(1), 1.179-3(h)(2).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. When the plaintiffs purchased their land in 1933, a fence enclosed an additional 15 plus acres which included five tracts of cedar trees. Over the years, the plaintiffs occasionally grazed cattle and goats on the disputed land, mended the fence and cut and sold some cedar wood. The court held that these activities were insufficient to show adverse possession of the disputed land. The fence was found to be a "casual fence" such that maintenance of the fence did not show adverse possession. **Rhodes v. Cahill, 802 S.W.2d 643 (Tex. 1990)**.

AGRICULTURAL LABOR

TORTIOUS STRIKE ACTIVITY. A farm labor union was found liable for negligently failing to control